

Classical Theory of Employment

BY

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Developed by Classical Economists: Smith, Say, Pigou, Fisher, etc.

Assumptions of the theory:

- ◆ Full employment level of resources
- ◆ Closed laissez faire capitalist economy
- ◆ Price flexibility
- ◆ Homogeneous labor
- ◆ Perfect competition market structure
- ◆ Money is considered as just the medium of exchange

Price flexibility i.e. rate of interest, wage, rent and profit maintains full employment in the economy.

Based on these assumption , classical economists argued that the full employment level of resources i. e. equilibrium level can be achieved through laissez faire policy in the economy. The demand and supply are two important market forces:

Components of Classical Theory

1. Say's law of market

Supply always creates its demand

2. Quantity theory of Money

$$MV = PT$$

3. Money market

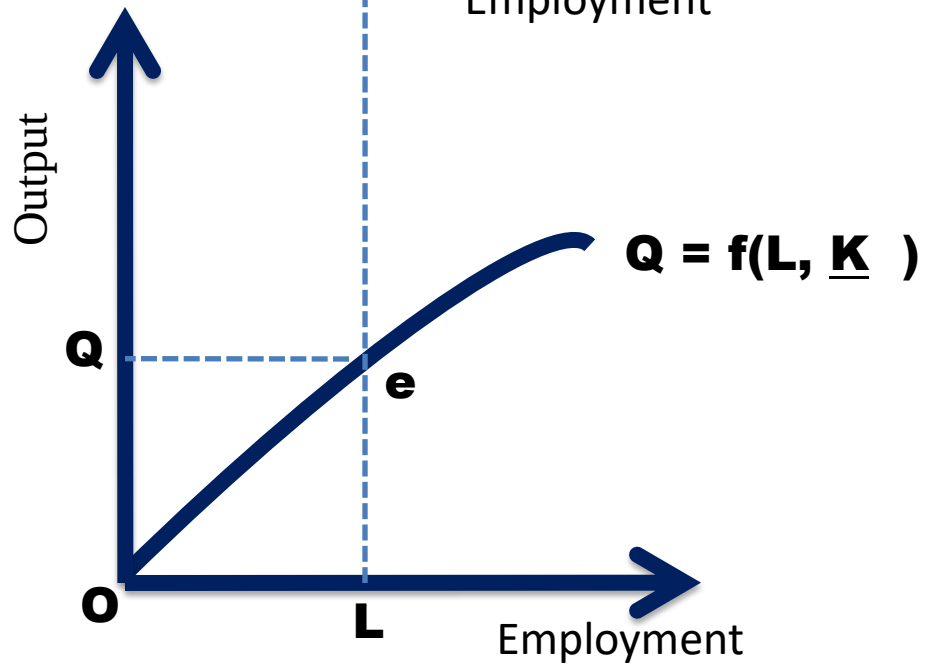
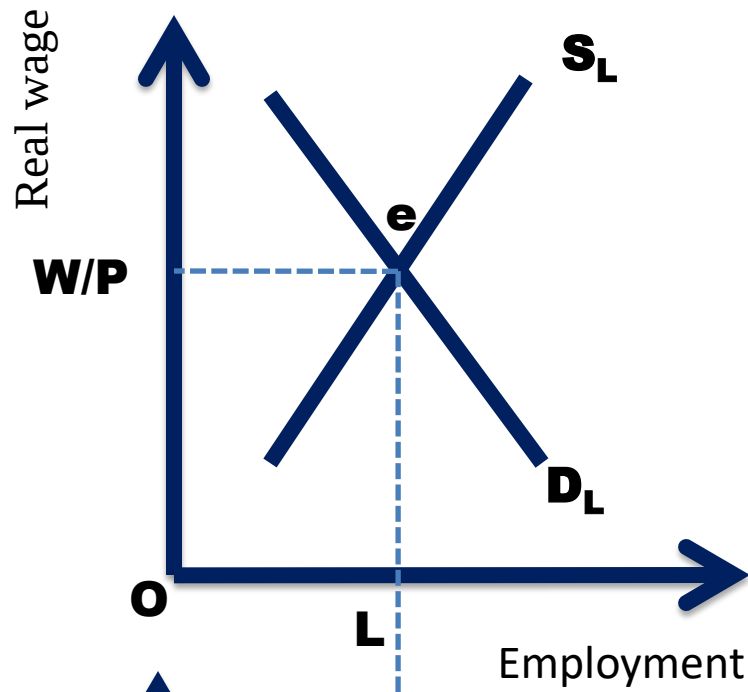
Money demand = Money supply

4. Product market

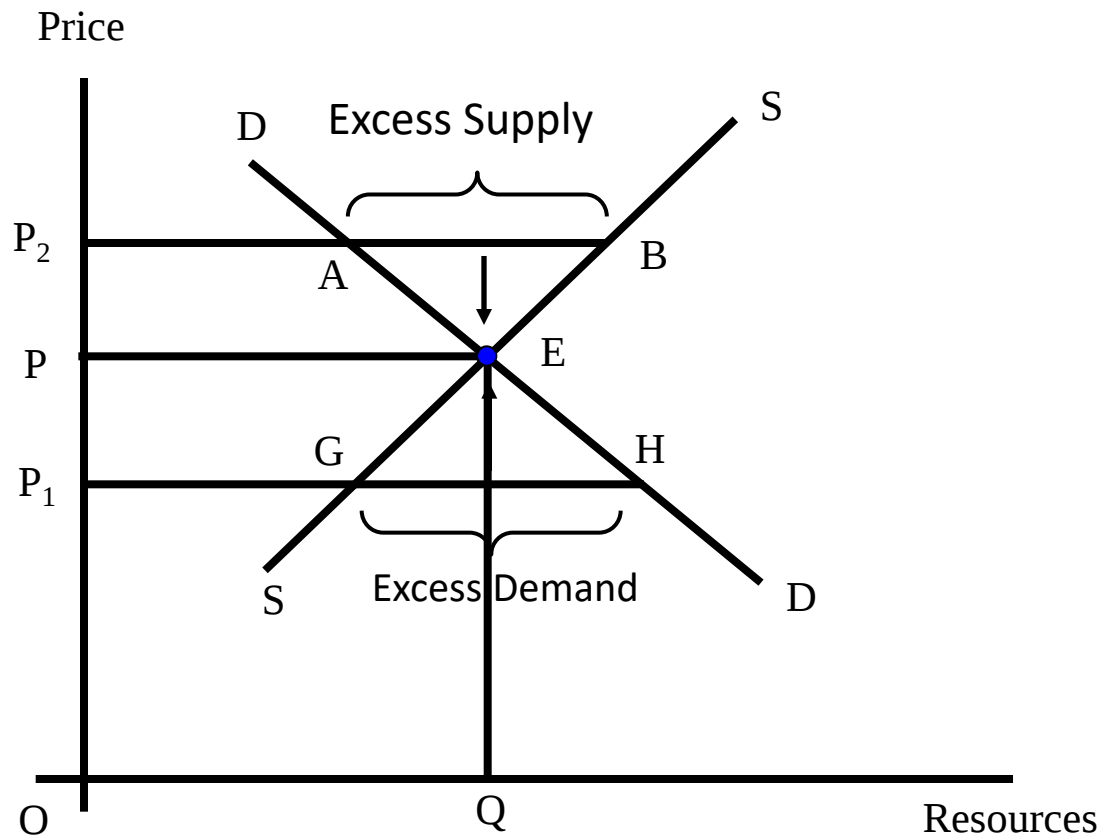
Demand = Supply

5. Production function

$$Q = f(L)$$



Full employment of the resources



Say' Law of Market

Jean Baptise Say,

French Economist of 19th century

Famously summarized as “ Supply always creates its own demand”

Assumptions

- ◇ **Full employment level of resources**
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- ◇ **Price flexibility**
- ◇ **Homogeneous labor**
- ◇ **Perfect competition market structure**
- ◇ **Money is considered as just the medium of exchange**
- ◇ **Long run time**
- ◇ **No leakage of money**

Based on these assumptions, the say's law argues that, the production of aggregate output created sufficient aggregate demand for its purchase.

Whatever produced in an economy, all is demanded. No over production and under production is possible. Income generating in the course of producing any level of output automatically results to an equal amount of spending sufficient to purchase goods and services produced in an economy.

Say's law in barter economy

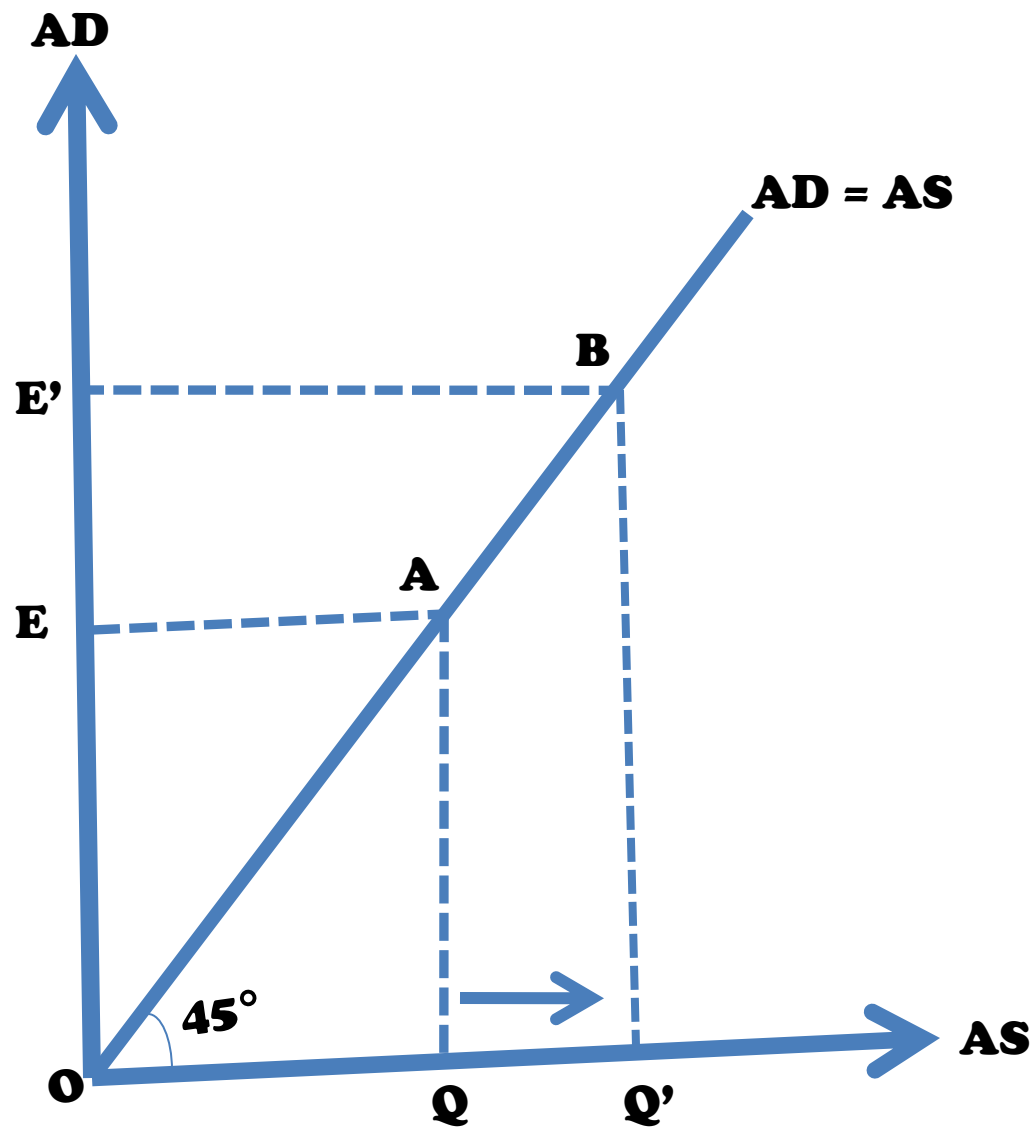
Say's law is applicable in a barter economy where goods are sold for goods.

Every good bought to the market is a demand for some other good.

Therefore, whatever produced is ultimately consumed in the economy.

Say's law in money economy

In classists view money is used as a medium of exchange. People hold money to facilitate the transaction of goods and services. The money just facilitates the direct barter of “ goods for goods” into the indirect exchange of “goods for money and money for goods”



Quantity Theory of Money

Irving Fisher

The Purchasing Power of money , 1911

Famously known as equation of exchange i. e. $MV = PT$ or $MV = PT + M'V'$

Assumptions

- ◇ **The general price level is dependent variable**
- ◇ **The total volume of transaction (T) and velocity of money (V) , remain constant**
- ◇ **M, V, P, T are independent to each other**
- ◇ **Full employment of all factors of production**
- ◇ **Role of money as the medium of exchange**

Based on these assumptions , the is based on an essential function of money i.e. money acts as a medium of exchange. Money is not needed for its own sake, but to exchange it for goods and services. It means money helps to purchase goods and services.

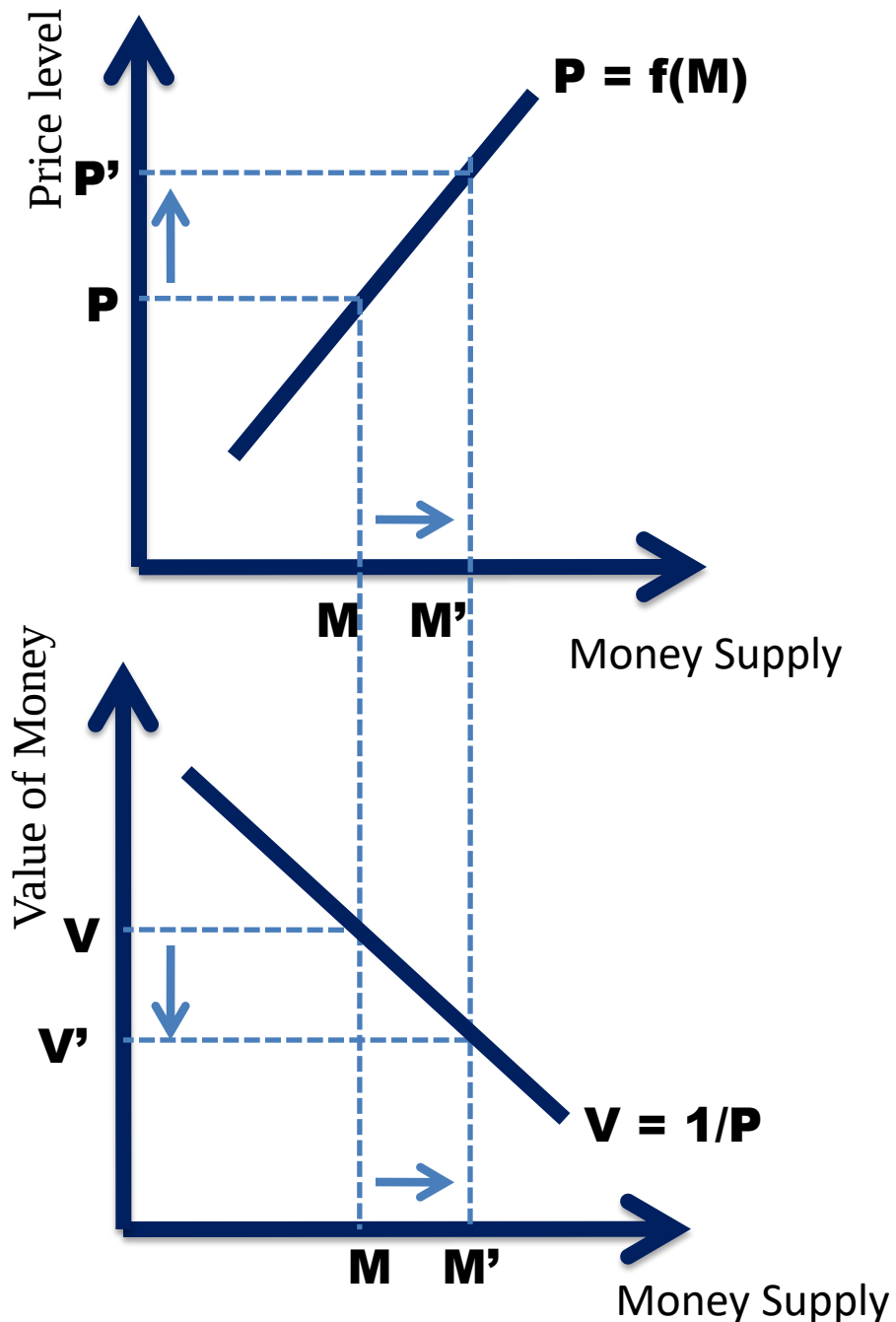
Money Demand

The product of P and T in the Fisher's equation of exchange represents the value of all goods and services bought in transaction during any period of time. The value indicates the total quantity of money required to transact the volume of output. Hence, the demand for money in an economy is equal to the market value of goods and services transacted

Money Supply

The product of M and V in the Fisher's equation represents the total money expenditure or supply of money during a given period of time of an economy.

According to Fisher, the purchasing power of money i.e. value of money depends upon the quantity of money relatively to the amount of goods and services to be purchased. The money demand must equal money supply of an economy during any period and this equality maintains the smooth functioning of any economy.

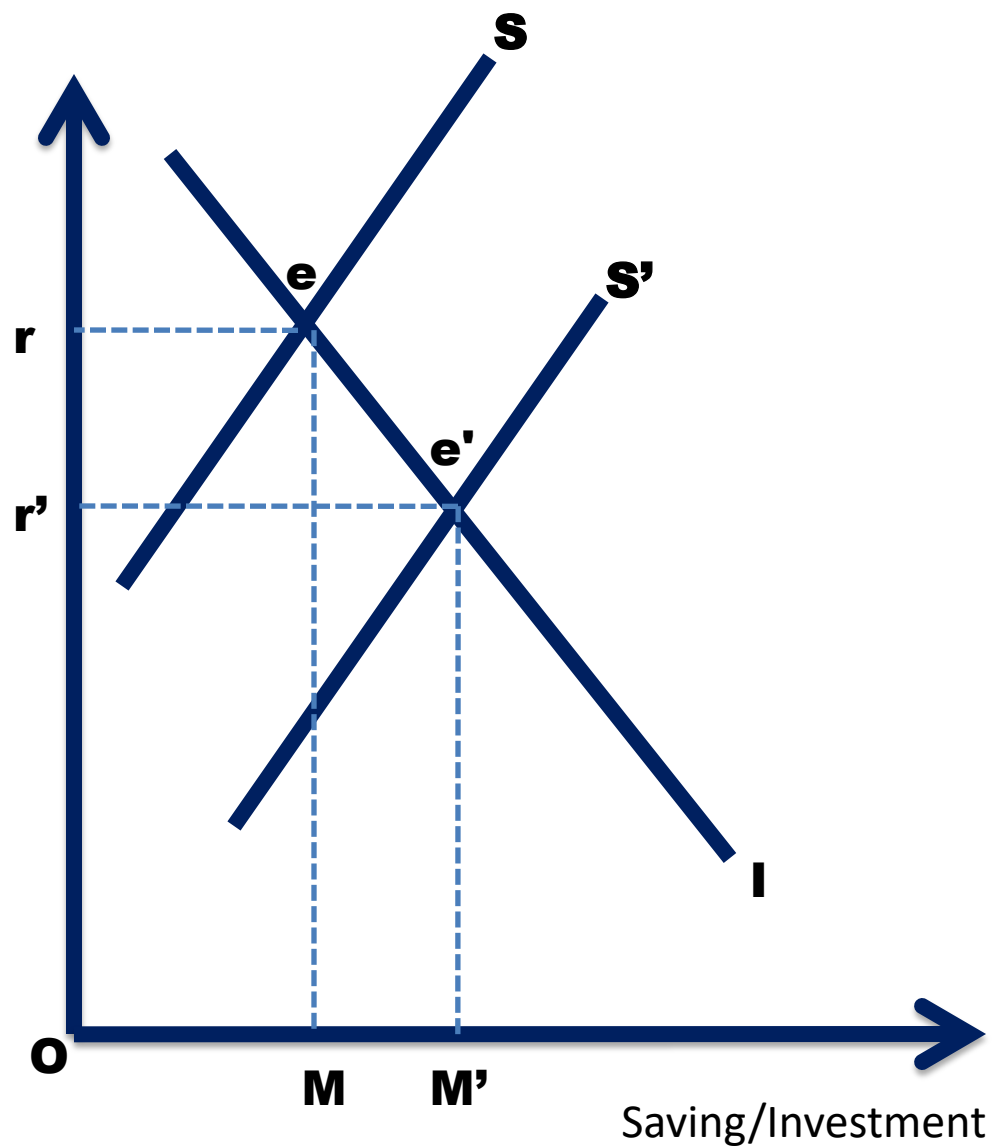


The quantity theory of money explains the relationship between quantity of money supplied and the general price level. There exists a positive relation between the quantity of money supply and the general price level and an inverse relation between quantity of money supply and value of money.

Product Market

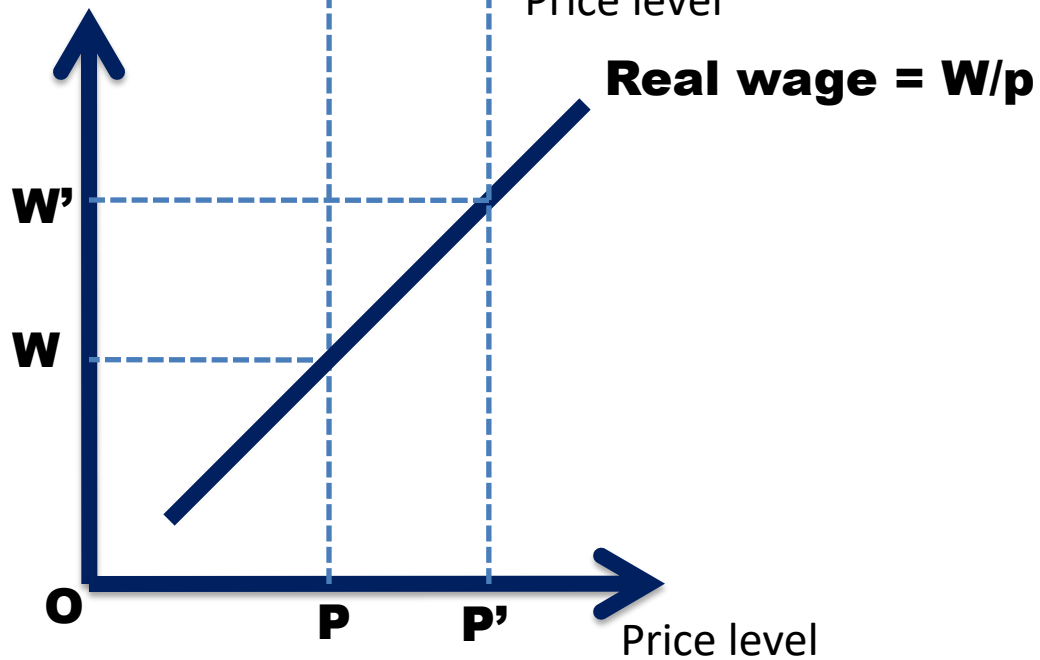
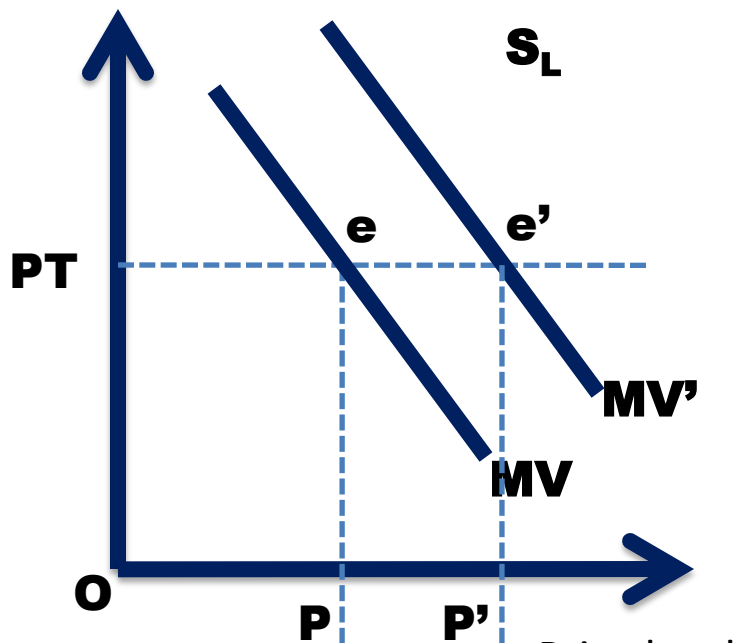
According to Say's law the entire income generated at the full employment level of resources must be spent on the purchase of whole output produced. The total output consists of consumer goods and investment goods. Total income consists of consumption and saving. The part of whole income is not consumed because a part is saved and this saving must be used in investments. Therefore, saving equals investment. There exists an inverse relation between investment and rate of interest and positive relation between saving and rate of interest. The equality between saving and investment maintains product market equilibrium.

Rate of interest



Money Market

According to Fisher, the total volume of output is equal to the total expenditure on such goods and services. In the long run the volume of goods and services (T) remains constant at full employment level of resources. Similarly, the price level is determined by the quantity of money supply. Therefore, there exists a positive relationship between quantity of money supply (M) and price level (P).



Criticisms on Classical Theory of Employment

J.M. Keynes in his “The General Theory of Employment Interest and Money” in 1936, made a frontal attack on the classical thinking and Say’s law of market on the following grounds:

- ◆ Supply does not create its demand.**
- ◆ Demand creates its own supply**
- ◆ Self-adjustment not possible**
- ◆ Money is not neutral**
- ◆ Over/under production is possible**
- ◆ Unemployment situation is normal**
- ◆ State intervention**
- ◆ Wage cut no solution**

Thank You Very Much..

